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Islamic Finance and Insolvency

Mahesh Uttamchandani, Discussant

"Islamic finance is becoming one of the hottest areas in banking and insurance in the world"

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Just as surely as insolvency practitioners have had to become experts in previously popular methods of finance: from structured lending to leveraged buyouts to hedge fund and private equity; Islamic finance promises to be one of the key new issues for practitioners.

What is Islamic Finance?

Islamic finance is based upon *Shariah* principles derived from the Holy *Qur'an* and the *Sunna*, and its central feature is the prohibition of payment and receipt of interest (*riba*). The explanations for the Islamic ban on interest that Muslim scholars have proposed are that interest serves as unearned income, it prevents full employment, and it can lead to monetary crisis. Other *Shariah* restrictions that affect Islamic finance include those against speculation and gambling (*maser*), uncertainty of subject-matter and contractual terms (*gharar*), and capital that has no social purpose beyond unfettered return.

Although *Shariah* imposes a ban on interest, it recognizes capital as a factor of production and allows owners of capital to share in a surplus that is uncertain as long as there is no prior claim on interest. Thus, a viable alternative to charging interest has been profit-sharing with a predetermined ratio. The Western system of equity financing is probably most comparable to Islamic finance. Depositors in Islamic banks are like shareholders who earn dividends when the bank makes a profit and lose a portion of their savings when the bank suffers a loss. The main restriction is that the depositor is not entitled to any addition to the principal sum unless he/she partakes in some risk.

Modes & Methods

There are several basic Islamic financing methods, each of which can be understood under the framework of existing Western financial instruments. They are as follows:

Murabaha, or cost-plus financing, is a method of asset acquisition finance. The transaction occurs when the bank purchases an asset at the request of its client, and then sells it back to the client on a deferred sale basis with a mark-up. The mark-up is determined before the purchase takes place and cannot be modified during the life of the contract. *Marabaha* is primarily applied to trade finance, but can also be used for real estate and project financing.

Ijara* and *Ijara wa-Iqtina are Islamic leasing arrangements that are comparable to Western operating and finance leases, respectively. *Ijara* is like an operating lease in that the bank will rent out an asset to its client for agreed payments throughout a specific period of time, but the client will not have the option of owning the asset. Similar to a finance or capital lease, *Ijara wa-Iqtina* allows the client to own the asset at the termination of the lease. In both cases, the leased assets must have a secure productive life and the lease payments cannot be based upon speculation.

Istinsa operates like a commissioned manufacture and is often used to finance long-term, large-scale facilities. The Islamic bank will manufacture assets, usually through a parallel contract with another institution, and then sell the assets to a client at a reasonable profit in exchange for taking on the risk of manufacturing the asset.

Mudaraba is similar to a Western limited partnership, whereby one party contributes capital to a business and the other party provides expertise. A profit-sharing ratio is arranged and agreed upon prior to undertaking the project.

Musharaka can be compared to a joint venture in that two parties provide capital towards the financing of a project that both may manage. Profits are shared based upon a pre-arranged ratio, but losses are distributed in proportion to equity participation.

Sukuk is a trust certificate that is the Islamic equivalent of a Western bond. The requirements are that it must be asset-backed, tradable, and with stable income. Most importantly, the identification of suitable assets on the issuer's balance sheet will determine the type of *Sukuk* to be issued.

Islamic Financial Markets

One of the major reasons financial institutions are trying to integrate and implement *Shariah*-compliant systems is that it opens the opportunity to tap into the funds of Islamic investors. While many Muslim countries have established Western style stock markets, some are now attempting to apply *Shariah* principles to trading. Tough challenges will arise in this process, especially given the Islamic restriction against gambling (*qimar*), but Malaysia has nonetheless already made great progress in this field with the establishment of Islamic brokerage houses and an Islamic stock index with 170 listings. The Islamic bond market has also made quite an impressive debut in recent years, reaching $6.7 billion in 2004 when it was not even in existence in 2000. The income streams from these bonds are based upon *Musharaka, Murabaha,* and *Ijara* structures rather than an interest system. As new Islamic financial products are being introduced, these markets will undoubtedly become more prevalent and sophisticated in the future.

Insolvency Concerns

An Islamic or *Shariah*-based legal system, such as those found in Pakistan, Saudi Arabia or Sudan is, in theory, able to adequately address insolvency issues arising out of *Shariah* banking arrangements. How these legal systems attempt to do this is a complex an interesting subject that is beyond the scope of this article. Of more immediate concern to most III members is the confluence of *Shariah* banking transactions with western, particularly common-law, legal systems. The United Kingdom, for example, already has a number of 'high-street' banks offering *Shariah* based financing products, sanctified by local religious boards.

The introduction of these products raises a number of general policy issues for western banks. In *murabaha* real estate transactions, for example, the bank effectively becomes a landlord. For most large commercial banks, this is a business that will be relatively new to them and is fraught with risk. Moreover, if a bank chose to offer Islamic finance products to depositors (as opposed to just borrowers), it would need to retain a clearly differentiated status between shareholders' capital and clients' deposits in order to ensure correct profit-sharing according to Islamic Law. This may be difficult for a publicly traded bank with many shareholders.

Separate and apart from these concerns, however, is the issue of how Islamic finance transactions will be treated in cases of insolvency. Given the relative novelty of these transactions in western countries, there is scarcely little jurisprudence on this topic, but it is not difficult to envision the types of issues that may arise in the coming years:

1. **The Bank as Landlord** – As described above, *murabaha* transactions can be crafted to allow for the purchase of real estate by the Bank, rather than the borrower, and the creation of what is, in effect, a traditional mortgage, by way of a long term lease with an automatic transfer of title at the end of the lease term. Upon default of a traditional mortgage, particularly in industrial situations, a bank may take the necessary steps to avoid becoming a 'mortgagee in possession', at least until it has satisfied itself that there are no serious environmental concerns with the property. Where a *murabaha* real estate transaction interacts with a typical restructuring law, however, an insolvent debtor may have the ability to disclaim the unexpired portion of the *murabaha* lease, thereby causing possession and control of the property to automatically revert back to the *de facto* control of the bank/landlord. Undoubtedly, banks will erect the necessary corporate firewalls to address such risks but, at a minimum, reputational risk should be a large concern.

2. **Substance over Form** – At a basic level, there is a concern as to whether the Bank's retention of title in both *Ijara* and *Ijara wa-Iqtina* transactions will be definitive in insolvency situations. Many modern personal property security laws provide that the law applies to any transaction which, in substance, creates a security interest. In the past, courts have therefore disregarded retention of title clauses in leases and have determined that the transaction was

in fact a financing one – requiring the interest to be perfected under the relevant personal property security regime. Absent specific carve-outs for Islamic transactions in such regimes, this issue is likely to be a significant one.

3. **The Bank as Controlling Mind of the Company** – In typical lender-borrower relationships, banks often take scrupulous care to avoid taking steps that could result in having them be deemed to be in control of their borrower. In *mudaraba* and, in particular, in *musharaka* transactions, this may be impossible. If a court could find that a bank, particularly on the eve of a company's insolvency, was a controlling mind of the company, there are a number of implications to consider:

(i) *Corporate Governance* – The biggest area of concern is the broad playing field where corporate governance issues and insolvency issues collide - particularly where modern insolvency laws have seen fit to impose liability on officers and directors for actions taken on the eve of insolvency. In many civil law systems, these can include business judgments made in good faith that nonetheless contribute heavily to the insolvency of the company. In many jurisdictions, regardless of the cause of the insolvency, officers and directors bear personal responsibility for particular statutory liabilities (employee withholdings, sales tax, etc.). Banks in *musharaka* transactions will have to ensure that these liabilities are met on an ongoing basis or risk exposing the bank to liability for them. Some jurisdictions impose fiduciary responsibilities on controlling minds of a corporation to ensure that lenders are not misled or wrongly induced into advancing further funds to a company. Finally, virtually every modern insolvency law imposes some level of liability on officers and directors for carrying on business (and accruing debt it is unlikely to be able to repay) during the pre-insolvency period. Banks will have to ensure that they take adequate steps to stop such trading from taking place.

(ii) *Equitable Subordination* – In recent years, courts have employed the doctrine of equitable subordination to correct what they have seen as various forms of malfeasance on the part of banks. It is difficult to anticipate precisely when this doctrine will be employed but it is not hard to see how the heavy involvement of a bank in the effective management of a business venture that becomes insolvent, could result in the bank's interest being equitably subordinated.

Undoubtedly, banks will attempt to mitigate the above risks through the use of corporate structures, carefully crafted contracts and even various forms of indemnities or insurance. If insolvency jurisprudence has taught us anything over the last 10 years, however, it is that corporate veils can be pierced and contracts set aside when the larger interests of stakeholders demand it. Put another way, no 'ring-fence' is entirely secure. This is not to suggest that *Shariah* financing transactions are to be avoided or feared. Rather, there are compelling arguments that, in fact, *Shariah*-based financing results in more efficient allocations of capital, greater stability and larger growth. Moreover, as we note above, the depth of financial markets in many western countries will ensure that the market responds to borrowers' increasing demands for a diversity of lending products. Instead, lenders and, perhaps more importantly, their professional advisors, will have to be sure to understand the complexities and risks associated with these transactions and ensure that appropriate measures are in place to reduce exposure